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(10) C. Eugene Beeckler
John I. Neely

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ARMY PROCUREMENT RESEARCH OFFICE
U.S. ARMY LOGISTICS MANAGEMENT CENTER
FORT LEE, VIRGINIA 23801

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FINAL

REASONS FOR LETTER CONTRACTS

by

C. EUGENE BEECKLER

JOHN I. NEELY

US ARMY PROCUREMENT RESEARCH OFFICE
US Army Logistics Management Center
Fort Lee, Virginia 23801

EXECUTIVE SUMMARY

A. BACKGROUND. Many research and development and production acquisitions require long administrative and performance leadtimes for continuity but have relatively short delivery or performance schedules. Late Congressional action, late receipt of funds by Executive activities, inadequate contract packages, and incomplete acquisition planning have further compressed leadtimes. Delays caused by these factors require procurement personnel to rely on contractor engineer estimates, preliminary vendor quotations, and other unsatisfactory pricing procedures. Negotiation of definitive contracts on such bases is an unacceptable pricing technique. A letter contract permits the immediate commencement of work when time does not permit negotiation of a definitive contract.

B. OBJECTIVES. The study objectives are to determine factors in the establishment of requirements, contract administrative leadtime and acquisition planning that lead to use of letter contracts and recommend any necessary changes to current policy and procedures for the use of letter contracts.

C. STUDY APPROACH. The study approach consisted of: reviewing publications, on-going research and other available data in the area; evaluation of current policy; selection, review and analysis of pre-award letter contract files at US Army Materiel Development and Readiness Command (DARCOM) Major Subordinate Commands (MSC's); evaluation of statistical data; and interviews of contracting policy and operations and requirement personnel at selected MSC's.

D. SUMMARY AND RECOMMENDATIONS. A letter contract is an essential option available to the contracting officer in selection of the method to achieve a two party agreement and immediate commencement of work for supplies and services for the national defense. But, excessive use of letter contracts leads to charges of poor planning and may deter effective negotiation of definitized contracts. The study identifies causes of letter contracts and recommends techniques to improve their use. Recommendations for improvement include: use of precontract costs advance agreements in lieu of letter contracts; improved qualitative letter contract reporting; raising the dollar threshold for Secretarial determination and findings, authority to negotiate Research and Development contracts; and reexamination of the Planning, Programming and Budget System to realistically reflect market/production constraints on procurement leadtimes.

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CHAPTER I

INTRODUCTION

A. PROBLEM.

Many research and development, and production acquisitions require long administrative and performance leadtimes for continuity but have short delivery or performance schedules. Late Congressional action, late receipt of funds by Executive activities, inadequate contract packages, and incomplete acquisition planning have further compressed leadtimes. This requires the use of contractor engineering estimates, preliminary vendor quotations, and other unsatisfacotry pricing procedures. Negotiation of definitive contracts on such bases in an undesirable pricing technique. A letter contract permits the immediate commencement of work when time does not permit negotiation of a definitive contract. But, excessive use of letter contracts leads to charges of poor planning and may deter effective negotiation of definitized contracts.

B. OBJECTIVES.

1. Determine the factors in establishment of requirements which lead to the use of letter contracts.

2. Determine the factors in the contract administrative leadtime which lead to the use of letter contracts.

3. Determine planning inadequacies which lead to use of letter contracts.

4. Recommend any necessary changes to current policy and procedures which will reduce the use of letter contracts.

C. STUDY APPROACH.

1. Review recent publications and on-going research in the area of letter contracts.

2. Select, review and analyze a sample of pre-award letter contract files at the DARCOM Major Subordinate Commands (MSC's).

3. Conduct interviews of requirements and contracting personnel knowledgeable with the letter contract actions previously reviewed and analyzed. Elicit causes of letter contracts not previously noted and suggested corrective actions.

4. Analyze all data gathered and synthesize the findings in the form of a written report to include recommendations for dealing with:

a. Factors in the establishment of the contracts package which lead to the use of letter contracts.

b. Factors in the contracts administrative leadtime which lead to the use of letter contracts.

c. Planning requirements to reduce the need for reliance on letter contracts.

d. Any necessary changes to current policies and procedures which will improve the use of letter contracts.

D. ORGANIZATION OF REPORT.

General letter contract policy and policy implementation and a recent General Accounting Office (GAO) report on letter contracts are discussed in Chapter II. Chapter III contains the data bases for the GAO and APRO reviews and results of interviews with the Air Force Systems Command (AFSC) and major advantages and disadvantages of letter contracts. Both offical

and unofficial causes of letter contract action are reviewed in Chapter IV. Chapter V discusses techniques for improving letter contract usage. Conclusions and recommendations are provided in Chapter VI.

CHAPTER II

GENERAL POLICY AND POLICY IMPLEMENTATION

A. INTRODUCTION.

This chapter reviews letter contract policy and its implementation. The review is confined to what are considered the most pertinent aspects of current policy and provides general commentary on implementation. Details on current usage are provided in subsequent chapters.

B. DEFENSE ACQUISITION REGULATION (DAR).

The DAR coverage for letter contracts is 3-408, the full text of which appears in Appendix A.

1. Definition.

DAR 3-408(a) defines a letter contract as a written preliminary contractual instrument which authorizes immediate commencement of manufacture of supplies or performance of services, including, but not limited to preproduction planning and the procurement of necessary materials.

2. Application.

Letter contracts may only be used when national defense demands a binding commitment to start immediate work and negotiation of definite contract to meet the acquisition need is not possible.

3. Limitations.

DAR 3-408 limitations on letter contracts use include:

a. A letter contract shall not be entered into without competition when competition is practicable. Where a letter contract award is based on price competition, an overall ceiling shall be included in the letter contract.

b. A letter contract shall include an agreement between the Government and the contractor as to the date by which definitization is expected to be completed and a definitization schedule, as required by DAR 7-802.5. This date shall be prior to:

i. The expiration of 180 days from the date of the letter contract, or

ii. Forty percent (40%) of the production of supplies, or the performance of the work, called for under the contract, whichever occurs first.

In extreme cases, an additional period may be authorized.

c. The maximum liability of the Government stated in the letter contract will be the amount estimated to be necessary to cover the contractor's requirements for funds prior to definitization, but this amount shall not exceed fifty percent (50%) of the total estimated cost of the procurement unless advance approval is obtained from the official authorizing the letter contract.

d. The total estimated cost shall not exceed the funds available for obligation and commitment in the appropriate allotment account. Therefore, the letter contract shall not describe, refer to, or otherwise commit the Government to a definitive contract in excess of the funds available for obligation and commitment at the time the letter contract is executed.[1]

Paragraph a. only requires a ceiling price if award is based on price competition although paragraph d. states the letter contract shall not refer to or commit the Government to a definite contract in excess of

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[1] Department of Defense, Defense Acquisition Regulation, 1976 Edition.

funds available for obligation and commitment at the time the letter contract is executed.

4. Definitization.

In unusual cases, if the parties cannot negotiate a definitive contract because of a failure to reach agreement as to price or fee, the mandatory letter contract clause in DAR 7-802.5 requires the contractor to proceed with the work and gives the contracting officer the right, with approval of the Head of the Contracting Activity, to determine a reasonable price or fee in accordance with Section III, Part 8, and Section XV of the DAR subject to the Disputes Clause.

There is no known instance of this provision being invoked, although contracting officers have stated the threat has been used to reach final agreement with the contractor.

DAR 7-802.5(a) states when it is known at the time of entering into the letter contract the price of the definitive contract will be based on adequate price competition or will otherwise meet the criteria of DAR 3-807.3, the requirement for cost or pricing data may be eliminated.

C. ARMY DAR SUPPLEMENT (ADARS).

The only pertinent reference to letter contracts appears in paragraph 1-403.54, "Departmental Preaward Review and Secretarial Notation." Subparagraph g. requires if proposed letter contract awards are to be reviewed by the Department of the Army level for notation by the Office of the Assistant Secretary of the Army (Research, Development and Acquisition) the file include the following information:

"(i) a statement as to the necessity for the use of a letter contract;

(ii) the duration of the letter contract in number of days from date

of execution;

(iii) the total estimated definitive contract amount, including the estimated cost of - - -

(A) new facilities,

(B) special tooling,

(C) activation or reactivation,

(D) Government-furnished property, and

(E) subcontracting; and

(v) the type of definitive contract proposed."[2]

D. ARMY MATERIEL DEVELOPMENT AND READINESS COMMAND PROCUREMENT INSTRUCTION (DARCOM PI).

The DARCOM PI coverage of letter contracts includes policy and procedures under paragraph 3-408 (Appendix B), a reporting requirement instruction under 3-408.60 and .61 (Appendix C), and a report format in Appendix C.

1. Policy and Procedures.

Only two comments are appropriate to DARCOM PI 3-408.

a. Content of Determination.

The requirement that the written determination includes steps taken to avoid the use of a letter contract is not addressed by DARCOM PI 3-408. In a significant number of cases this oversight throws doubt on the validity of the determination. Steps that can be taken to avoid a letter contract must include not only those available to the contracting officer, but also those available to requiring activity (slip schedules,

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[2] Department of the Army, Army Defense Acquisition Regulation Supplement, 1976 Edition.

request relief from higher level direction, forego the requirement, etc.).

b. Approval Level.

The other point addresses the fact that the letter contract shall be approved only by the Head of the Contracting Activity (HCA), and principal or deputy principal assistant responsible for contracts. HCA's with problems on the use of letter contracts have retained approval authority at the HCA level. Additionally, some MSC's make the requiring activity obtain HCA's approval for the use of a letter contract rather than the contracting personnel.

2. Reporting Requirements.

The instructions for the letter contracts report can use several refinements. The major subordinate command element that generates the contracting package, any activity outside the MSC that will contract for the requirement, and the ultimate user should be part of the letter contract report to DARCOM. An example is a DRAGON Night Tracker acquisition. The Electronics Research and Development Command's Night Vision and Electro-Optics Laboratory (ERADCOM NV&EOL) at Fort Belvoir, Virginia, was the cognizant technical element for the Night Tracker. The Mobility Equipment Research and Development Command (MERADCOM) provides contracting support for the NV&EOL. The TOW-DRAGON Project Manager (PM) initiated the requirement to support the US Army Infantry Center (USAIC) training to meet the urgent requirement of the Commander in Chief, US Army Europe (CINCUSAREUR). This situation is an excellent example of the cognizant technical element and contracting activity for the contracting package reacting to directions beyond their control.

The CINCUSAEUR perceived a change in threat and requested an accelerated Initial Operational Capability (IOC). The TOW-DRAGON PM reacted accordingly. This also is a good example of a letter contract award to permit immediate commencement of work in the interests of national defense. It shows a letter contract action for which none of parties involved in the acquisition should be criticized. Identity of the parties involved in an acquisition that results in a letter contract can be useful in determining particular Government activities associated with an excessive number of letter contract actions. This can be cause for management attention to the perceived problem activity.

The percentage of total estimated definitive value obligated by the letter and the percentage of the obligated amount expended by the contractor should be reported to track compliance with DAR 3-408.1(c)(ii) and 3-408.1(c)(4). The percentage of the obligated amount expended by the contractor can be obtained from DD Form 1423, Contract Data Requirements List, report or based on the contractor vouchers.

E. THE GENERAL ACCOUNTING OFFICE (GAO).

The GAO by Letter B-10524 dated November 16, 1979, submitted report PSAD-80-10 subject, "delays in Definitizing Letter Contracts Can be Costly to the Government" to the Secretary of Defense. Since the initial subject of the GAO review was the increased use of letter contracts by the Departments of the Army and Navy, it was tracked during the early course of this study. But the final report addressed post award aspects of letter contracts only and is therefore not as appropriate to this study's review of the pre-award aspects of letter contracts as originally thought. Nevertheless, the GAO report made two observations worthy of discussion.

1. Unilateral Determinations.

First, the GAO found no instances in which Navy or Army contracting officers made use of the unilateral determination clause to definitize contract prices, although the threat of a unilateral determination has been used to consummate agreement with contractor. The GAO said contracting officials were reluctant to make an actual unilateral determination because of the impact on relationships with the contractor. There are cases where, as a matter of principle, the Government must take such unpopular and extreme action. Such action can improve relationships with industry by demonstrating our willingness to: insist on arms length prudent man business dealings; and to invoke our contractual rights when necessary.

2. Incurred Cost Treatment.

The other important point is that incurred costs are not properly reflected in the negotiated profit rate. Both the DAR and the Armed Services Procurement Regulation Manual (ASPM No. 1) address this aspect of Weighted Guidelines Method of establishing a profit objective.

DAR 3-808.6(c) states:

> "c. In making a contract cost risk evaluation in a procurement action that involves definitization of a letter contract, unpriced change orders, and unpriced orders, under BOA's; consideration should be given to the effect on total contract cost risk as a result of having partial performance before definitization. Under some circumstances it may be reasoned that the total amount of cost risk has been effectively reduced. Under other circumstances it may be apparent that the contractor's cost risk remained substantially unchanged. To be equitable the determination of a profit weight for application to the total of all recognized costs, both those incurred and those yet to be expended, must be

made with consideration to all attendant circumstances; not just the portion of costs incurred, or percentage of work completed, prior to definitization."[3]

The ASPM No. 1, Chapter 3C, "Profit Analysis" states in part:

"Incurred Costs

If you are firming up a letter contract, a contract change or any other unprice action where costs have been incurred, there is virtually no cost risk associated with the incurred costs. Therefore, these incurred costs should be assigned a 0 risk weighting. Additionally, the "to go" portion (the estimate to complete) may be of less risk than if there were no incurred costs and could be assigned a weight outside the ASPM ranges. If the Government caused the late definitization of the letter contract, equity may require you to weigh this circumstance in your profit objective."[4]

Thus the DAR and ASPM support consideration of incurred cost in development of profit objectives for letter contracts under the appropriate circumstances. Based on the GAO report, this is not being done. This must be done, if appropriate, even though it means invoking the right of the Government to make a unilateral determination.

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[3] Ibid.

[4] Department of Defense Armed Services Procurement Regulation (ASPM No. 1) Contract Pricing (The 1975 Edition).

CHAPTER III

DATA BASE COLLECTION AND ANALYSIS

A. INTRODUCTION.

As described in Chapter II, this study focuses on reasons or circumstances that cause the award of letter contracts and the General Accounting Office (GAO) report was primarily concerned with the timeliness of definitizations, the impact of incurred costs on profit and fee negotiations, and lack of government use of the letter contract unilateral determination rights. These differences in scope resulted in different data bases and analyses.

B. DATA BASE PARAMETERS.

The GAO examined the procurement records of 87 of 389 letter contracts awarded between 1 July 1973 and 30 March 1979 that had not been definitized within the 180 day period cited in DAR 3-408(c)(3)(i). This study took a different approach. The time period selected was relatively short and as recent as possible. It permitted selection of letter contract actions with which field personnel are most familiar, and enhanced knowledgeable discussions. Thus to assure recency of the letter contracts to be reviewed, it was decided to pick a base of 15 calendar months or five fiscal year quarters for a review of letter contract files. In case of MSC's in St. Louis, MO and Detroit, MI, that base period was the third quarter fiscal year (FY) 1978 through the third quarter FY 1979 (1 April 1978 through 30 Jun 1979). The base period for all other MSC's is the fourth quarter FY 1978 through

the fourth quarter FY 1979 (1 July 1978 through 30 September 1979). The St. Louis MSC's were visited the end of June 1979 and the Detroit MSC's were visited in early July 1979. All other MSC's were visited in the last week of September 1979 and later. If the MSC had few letter contracts reported during the above timeframe the study team looked at older letter contract awards.

The letter contract actions reviewed consisted of all reported on the DARCOM letter contract report, RSC: DRCPP-307, if the number was low enough to permit review of all actions within the study resources. If the number was too high to permit review of all actions within the study resources, a sample was selected to give a variety of Principal Contracting Officers (PCO's), negotiators, requiring activities and personnel, technical requirements, dollar values, and percentages of total estimated definitive value obligated by the letter contract.

Field data collection was in two phases. The first phase consisted of the letter contract pre-award file review and extraction of data pertinent to the reason or reasons that caused the need to use a letter contract. Limited discussions were held with contracting policy and operations personnel. This data was analyzed and appropriate questions were developed for the second phase. The second phase entailed revisits to most MSC's. This phase was used to verify the information reported on the letter contract report to HQ DARCOM and pre-award file documentation collected during the initial visits.

In addition to the primary analysis of reasons for letter contracts, an analysis was made of letter contract data for fiscal year 1979 only.

The data was derived from the fiscal year 1979 307 reports and the "Central Procurement Report" RCS: AMCRP-127 (hereafter referred to as the 127 Report).

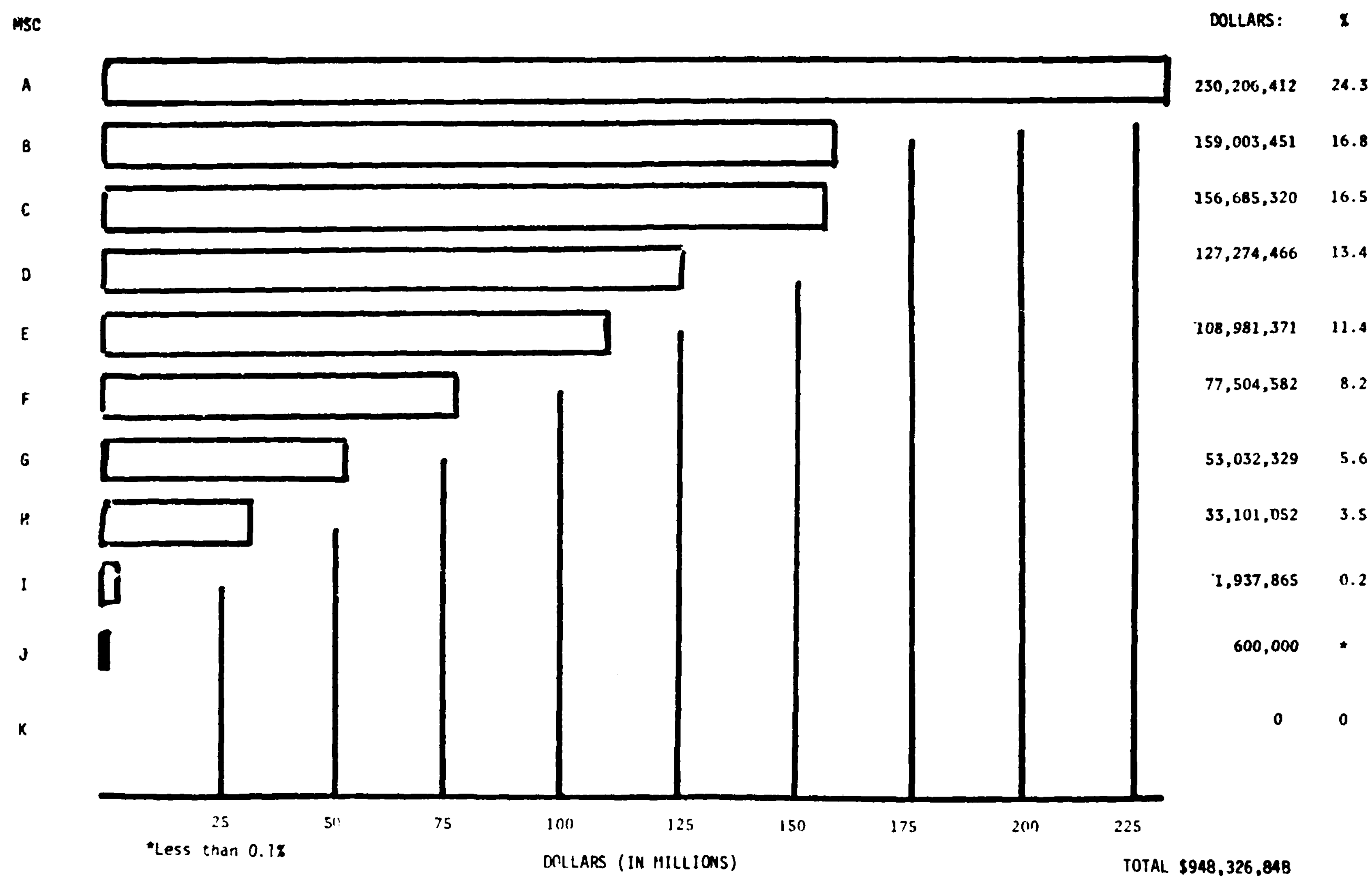
C. <u>NUMBER AND DOLLAR VALUE OF LETTER CONTRACTS</u>.

Based on the 127 Report, MSC's of DARCOM awarded a total of 263 letter contract actions during fiscal year 1979 (FY 79) for a total dollar value of $948,326,848 (Figure 1). Letter contract actions represent 1.1% of the total DARCOM central contracting actions over $10,000 and 12.5% of the total award value of FY 79 actions over $10,000. The use of letter contracts by individual MSC's ranges from 24.3% of the DARCOM total for MSC A to zero percent for MSC K. MSC J had one letter contract for $600,000 but it was for a requirement of another MSC.

The study team reviewed the pre-award files of 64 or 24% of the FY 79 letter contract actions and 44% of the dollar value of FY 79 letter contract actions. In addition to the FY 79 letter contract actions reviewed the study team reviewed a total of 38 earlier letter contract actions with total value of $85,139,550. In summary a total of 112 letter contract actions with a total value of $505,586,610 were reviewed.

FIGURE 1

MSC LETTER CONTRACTS DOLLAR VALUE FY 79



D. FISCAL YEAR 1979 LETTER CONTRACTS BY QUARTER.

Figure 2 compares the total number of FY 79 letter contract actions and all other contractual actions over $10,000 by quarter on a percentage basis. This data was subjected to a statistical analysis. The analysis indicated that an unusually large number of letter contract actions were awarded during the fourth quarter. In fact, 146 out of the 263 letter contract actions, or 56%, were awarded during the last quarter. A chi-square test for independence was performed and found to be significant at the 99% level. Evidently the use of letter contracts depends on whether or not it is the fourth quarter. That is, a significantly large number of letter contract actions were awarded in the fourth quarter.

Figure 3 depicts FY 79 letter contract obligations and all other contractual obligations on a percentage basis. Figure 3 shows that 44% of letter contract obligations occurred in the fourth versus 24% of all other obligations over $10,000.

E. INTERVIEWS.

1. DARCOM MSC's.

The interviews on initial field visits were conducted primarily with contracting policy personnel, although some contracting operations personnel were interviewed. The follow-up field visits were conducted to verify data collected and analyzed from the initial visits. Additionally, contracting operations (Principal Contracting Officers(PCO's)) and contract specialists/negotiators and requirement (project/program engineers/

PERCENT LETTER CONTRACT ACTIONS

VS

ALL OTHER ACTIONS OVER $10,000 - (By Qtr) FY79

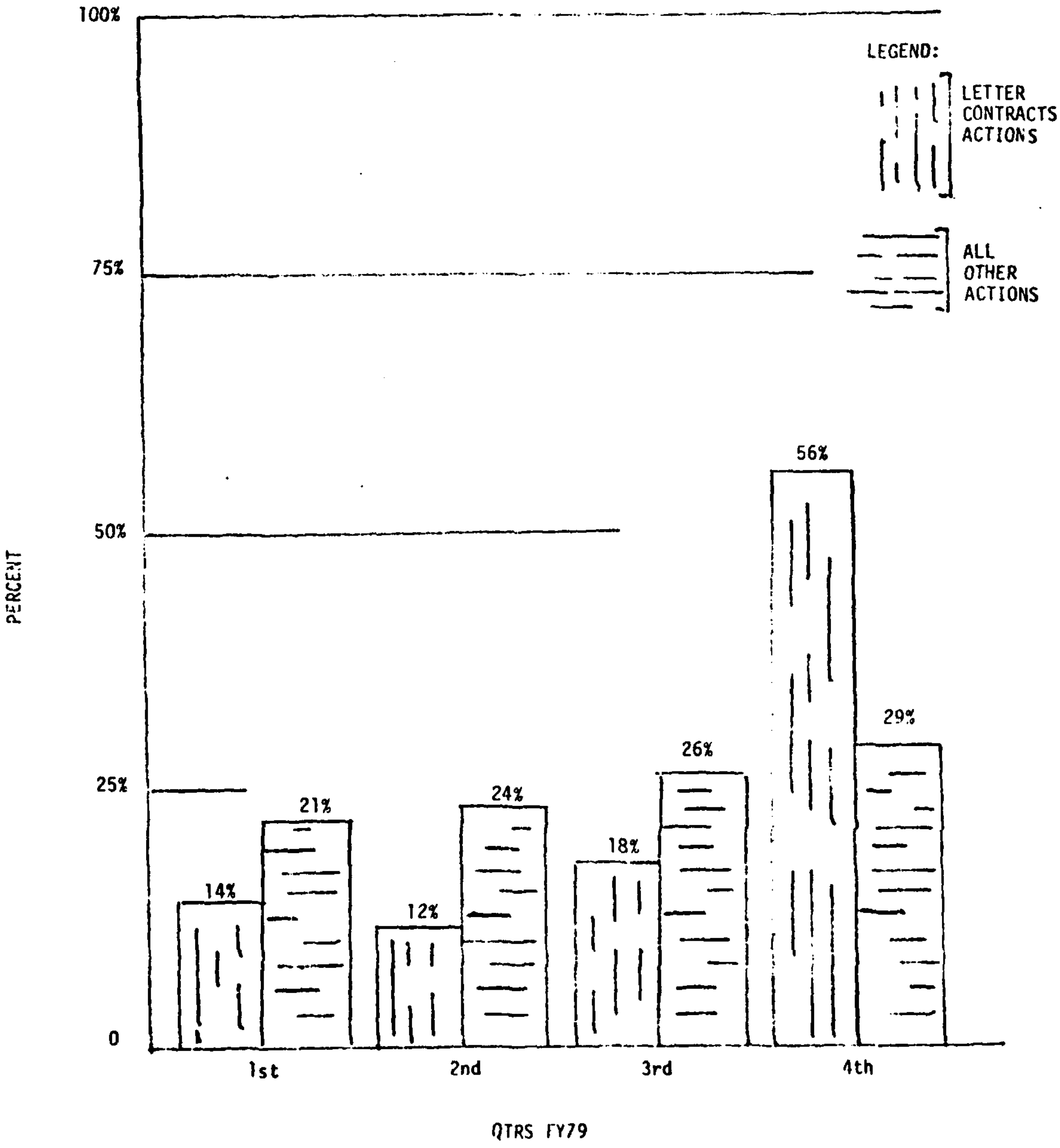


FIGURE 2

LETTER CONTRACT OBLIGATIONS (By Qtr) FY79

VS

ALL OTHER OBLIGATIONS OVER $10,000

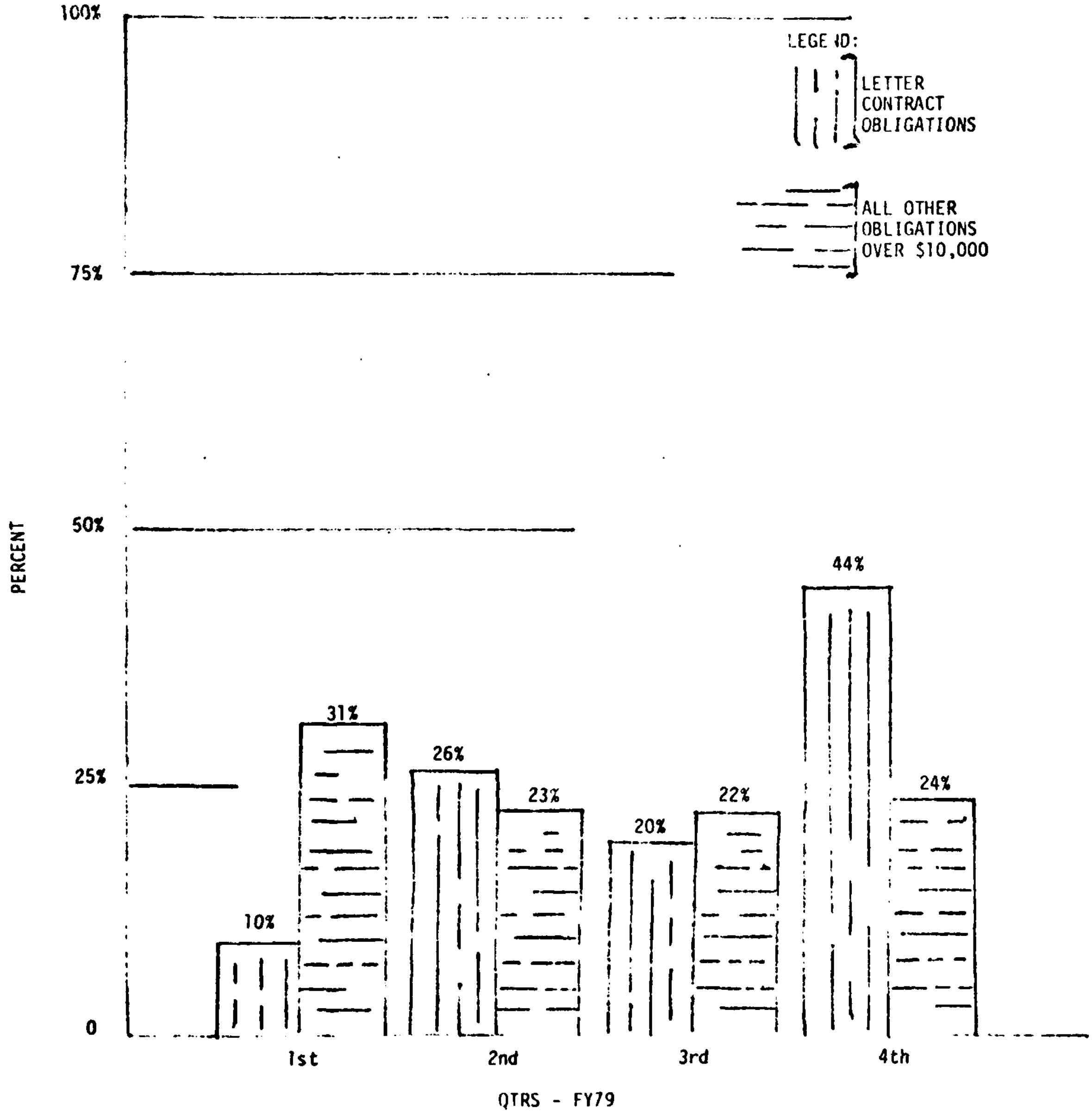


FIGURE 3

scientists, commodity managers and production specialists) were interviewed. Supervisory personnel of contracting and requirements elements of the MSC's were also interviewed. This permitted determination of unofficial reasons for use of letter contracts (not cited in pre-award documentation), collection of personal perceptions of the causes of letter contract usage and techniques for minimizing the use of letter contracts, and obtain the requiring or technical elements perspective of the need to place letter contracts.

2. Air Force Systems Command (AFSC).

The AFSC has only general policy on the use of letter contracts. Subordinate commanders are permitted to set approval levels for use of a letter contract at their own discretion. The Commander AFSC requires advance notice of potential need for a letter contract if a major program is involved.

AFSC employs two techniques to monitor the use of letter contracts. Senior Review Boards for letter contract actions are held at HQ AFSC. Also, the Program Manager must give periodic briefings to the Commander AFSC. One mandatory briefing chart is the use of letter contracts.

F. REASONS FOR LETTER CONTRACTS.

Based on the letter contract pre-award files documentation, the reasons for the use of letter contracts in the sample were accumulated. The results are shown in Table 1. Since more than one reason was cited in some instances for letter contracts, the total number of reasons is 127 versus 112 letter contract actions reviewed.

TABLE 1

REASONS FOR LETTER CONTRACTS

(DATA TAKEN FROM "DETERMINATION & APPROVAL" DOCUMENTS)

REASONS:		FREQUENCY	% OF TOTAL
1. To Meet Required Mandatorv Schedules:		97	76.4
Required by:			
Requiring Activity		(51)	(40.2)
DOD		(24)	(18.9)
DA		(12)	(9.5)
Other Svcs; i.e., AF, Navy, FMS		(7)	(6.5)
Congress		(2)	(1.6)
HQ DARCOM		(1)	(0.7)
2. To Avoid a Production Break		15	11.8
3. To Obligate Funds Prior to End of FY		8	6.3
4. To Correct Out of Stock Situation		7	5.5
	TOTALS	127	100.0

The reason most observed was to meet a mandatory schedule. This reason is utilized for both research and development and supply contracts. It includes providing data for Army System Acquisition Review Council (ASARC) and Defense Acquisition Review Council (DSARC) milestones, meet Congressional mandates, and a variety of other required schedules. The reasons for the use of letter contracts will be discussed in greater detail in the next chapter.

G. ADVANTAGES AND DISADVANTAGES.

The following paragraphs will discuss the more commonly accepted advantages and disadvantages to the Government to the use of letter contracts based on interviews of field requirements and contracting personnel.

1. Advantages.

There are two major advantages to the use of letter contracts.

a. Permits Immediate Performance.

A letter contract permits the immediate commencement of contract performance. The interests of national defense can demand the contractor be given a binding commitment by Government although sufficient time is not available to permit execution of a definitive contract. The need to meet the threat can dictate the use of letter contract. One aspect of this problem was clearly discussed in Business Week in a feature article entitled "The Defense Production Gap. Why the US Can't Rearm Fast."[5] The article notes severe constraints on aerospace systems in particular but also tactical missiles, tanks and guns, electronic systems to back them up and perhaps ammunition. The chase of defense dollars in competition

[5] n.p. McGraw-Hill, Inc., Number 2622 (February 4, 1980) pp, 80-86

with commercial demands for limited resources of large forgings and castings, beatings, machining capacity, semi-conductors (integrated circuits) metals and manpower can drive the increased use of letter contracts to place a first demand over other weapons systems or other defense needs.

b. <u>Avoids the Loss of Funds and Reprogramming Actions</u>.

The other major advantage that accrues to the Government by use of letter contracts is avoiding the loss of funds and reprogramming actions that seriously delay or result in cancellation of an identified program need.

Operating and Maintenance Army (O & MA) funds can only be obligated in the fiscal year for which they are appropriated. Research, Development, Test and Evaluation (RDT&E) funds can only be obligated in the fiscal year appropriated, plus the next fiscal year. Procurement Army (PA) appropriations must be obligated in year appropriated, plus the two subsequent fiscal years. Additionally, many programs are subject to higher level, including Congressional, reviews and approvals of reprogramming actions. Many Program/Project Managers and MSC's are more willing to use letter contracts to avoid loss of funds and reprogramming actions. This becomes an obvious attitude when it is recognized that the receipt of new obligation authority can take from twelve to twenty-three months. The field must submit budget data in August of a calendar year prior to the calendar year in which the appropriation year starts; e.g., this August 1980 for Fiscal Year 1982 to start 1 October 1981. If the field fails to obligate monies that expired 30 September 1980, the field

will have missed the August 1980 budget input date for Fiscal Year 1982. Now they may have to wait until August 1981 for the Fiscal Year 1983 budget input cycle. If Congress does not take final action until late December 1982 on the Fiscal Year 1983 budget, a minimum twenty-three month schedule slippage occurs. It must be pointed out that this is a worse case situation. Reprogramming actions or supplemental appropriations can be obtained, but at the expense of time.

2. Disadvantages.

a. Loss of the Benefits of Competition.

One hundred and twelve letter contract actions files were reviewed by the study team. None of the letter contracts actions were the result of a competitive procurement.

Two cases of letter contracts resulting from competitive procurements were mentioned to the study team members during field interviews but the appropriate files were not reviewed. If the circumstances of the acquisition meet the requirement of adequate price competition under DAR 3-807.1(b).1, use of a letter contract challenges the integrity of the Government contracting process. In one case noted, it was confirmed by telephone that a MSC had consistently solicited competitive fixed price offers and received the same. The MSC then awarded letter contracts with ceiling prices at the offered price. On the surface this is in complete agreement with DAR 3-408(c)(2). The awards can be challenged because the letter contract makes a definitized agreement subject to cost or pricing data, and is obviously a downward adjustment only. This situation is pointed

out because it has an impact on the Government's dealing with industry and the Government has extreme sensitivity to the integrity of the contracting process. When the price competition is adequate and a letter contract is awarded, the Government is alluding to the possibilities that either the contractors cannot be trusted or collusion is suspected. Unless the Government has a strong case which is presented in open discussions with the contractors, if mistrust is the issue, or in a court of law in the case of collusion, the contractors will in turn be equally distrustful of the Government.

Contracting personnel have been of the opinion that because sole source contracts take less time to process, program managers sometimes delay submission of requirements until a sole source award is the only feasible way of getting a contract before the end of the year.[6] This statement can be extended to include the use of letter contracts.

b. Loss of Negotiation Leverage.

Once the Government has awarded a letter contract, it is essentially and practically a commitment to obtain the requirements from a particular contractor. This is especially true when 100% of the estimated value of the definitive contract is obligated by the letter contract and based on Government's lack of unilateral price determinations. During field interviews, only one case of a letter contract termination was noted. It was a cost type research and development letter contract which was terminated for convenience because of cost growth. Another school of thought is that under cost type sole source research and develop-

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[6] Washington, DC, The Bureau of National Affairs, Federal Contracts Report No. 809 (3 December 1979) p. A-26

ment (R&D), the Government has little or no leverage and a letter contract contributes to the lack of leverage.

Leverage can be lost in any acquisition that results in a letter contract. First, the contractor has booked the letter contract award as a sale and his emphasis can shift to other sales that are not consummated. Additionally, the more costs accumulated by the contractor against the letter contract, the less the contractor's cost risk. Where a ceiling price is placed in the letter contract and the contractor is aware of our method, the contractor will assure that his offered price is high enough to absorb any reasonable contingency plus provide him an appropriate profit (not necessarily a reasonable profit from the Government's perspective).

Similar leverage is lost by Government contracting personnel in obtaining cooperation of the pertinent technical personnel. Here the technical personnel shift their emphasis to technical areas that are not under contract or are jeopardizing overall program accomplishment. In essence the technical personnel look at obligations, not definitizations. If the letter contract has 100% of the estimated cost obligated the technical personnel know the pressure is on the contracting personnel for prompt definitization. If less than 100% of the estimated cost is obligated by the letter contract, the technical personnel know the pressure is still on the contracting officer to achieve prompt definitization. The technical personnel are sure that the obligation rate can rise to 100% of the estimated cost if definitization is delayed. Technical personnel also know termination of the effort is unlikely.

c. Contractor Incurs Costs Without Risk.

A contractor incurring costs against a letter contract does so with little or no risk. If a definitive cost type contract is contemplated, the cost risk is generally limited to the disallowances established in DAR, Section XV. But if a contractor's accounting system is adequate for a cost type contract he is usually familiar with Section XV of the DAR. In the case where a definitive firm-fixed-price (FFP) contract is contemplated, the contractor avoids the 0%-Government and 100%-contractor cost risk associated with an FFP contract.

There is a risk associated with any letter contract that is seldom incurred but is, nevertheless, recognized as a risk. That risk occurs:

> "Where cost limits stipulated in letter contracts or letters of intent are consistently disregarded and increased by successive amendments after they have been exceeded and execution of the definitive contracts based on the letter contracts or letters of intent is delayed until the work involved is entirely or practically completed, the final contracts will not be considered binding obligations of the Government and credit for payments under such contracts, equal to the percentage fee provided for in the preliminary agreements, will be disallowed."[7]

Since the foregoing is the only known circumstance where the contractor receives no fee payment on work under a letter contract,

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[7] US General Accounting Office, B-110609, 14 Jan 1954, 33 Comp, Gen. 291

the risk of this occurring again is remote. The Government, as pointed out earlier in this chapter, must consider the change in contractor risk due to costs incurred under a letter contract in definitization of the letter contract profits or fees. Otherwise, the contractor will receive fee payments in excess of what is a reasonable fee from the Government's viewpoint.

d. Additional Administrative and Potential Contract Performance Costs.

It is generally believed letter contracts entail additional administrative costs. These costs are for items such as:

i. Initiation and processing the request for approval of a letter contract.

ii. Initiation and processing the letter contract instrument.

iii. *Audit review of vouchers when a firm-fixed-price de*finitization is contemplated.

There is no consensus on additional contract performance costs incurred by the use of a letter contract. Some people contend this disadvantage is similar to the one on loss of negotiation leverage. In the case of a sole source cost type R&D letter contract, it would appear there are no additional contract performance costs. But other people contend that even in this case the contractor would lack the incentive to perform as efficiently and economically as in a definitized contract. Once costs are booked against a letter contract, it is difficult to negotiate them out of the definitive agreement. In other words, it is harder to negotiate out inappropriate incurred costs on a letter contract

than to disallow and uphold that disallowance under a definitive cost type contract. The matter becomes more difficult if the letter contract contemplates a definitive firm-fixed-price contract. If price competition is not involved and the letter contract has no ceiling price, the cost of performance prior to definitization is incurred in a cost type contract environment with little or no incentive for economical and efficient performance by the contractor. In fact, it may be the contractor's opportunity to experiment with contract performance at the expense of the Government. He can use the contract to train lower skill level personnel than contemplated with a resulting overall increased cost due to scrap, salvage and rejects. The contractor can develop a new vendor at a higher cost than utilizing proven lower cost vendors. It is not proven letter contracts lead to this type of problem, but it is true opportunity for temptation exists.

e. Charges of Poor Acquisition Management.

The use of letter contracts can be construed as an indication of defective acquisition planning. The number or dollar value of letter contracts constitutes an unacceptable situation is obviously subjective. Even though the causes for the need to use letter contracts are numerous and originate in organizations outside of the control of DARCOM and its MSC's, the letter contracts were awarded by DARCOM contracting offices. The point is the existence of letter contracts can create a negative image of the US Army Materiel Development and Readiness Command's (DARCOM's) acquisition mission.

CHAPTER IV

REASONS FOR LETTER CONTRACTS

A. INTRODUCTION.

The reasons for letter contracts are divided into two categories, official and unofficial. Official reasons are those cited in the letter contract action pre-award file documents, including requests for and approval of the use of letter contracts and sole source and review board actions. Unofficial reasons are derived from other contract file documentation such as notes, telephone conversation records, messages, letters and interviews of contracting and requirements personnel. Some reasons are both official and unofficial.

B. OFFICIAL REASONS.

The official reasons for the use of letter contracts are presented in the order of frequency listed in Table 1, Chapter III.

1. Mandatory Schedules.

Mandatory schedules are generated by all levels of Government involved in the acquisition process. Mandatory schedule causes include Initial Operational Capability (IOC's) dates, Development Test (DT) and Operational Test (OT) dates, ASARC and DSARC milestones, component delivery schedules in support of end items manufactured or assembled by industry on a Contractor Owned/Contract Operated (COCO) or Government Owned/Contractor Operation (GOCO) basis or on a Government Owned/Government Operation (GOGO) basis, training schedule dates, and Mandatory schedules set by the ultimate end user, and Congressional mandates.

a. Requiring activity.

For the purpose of this report requiring activity includes item or system managers and program or project offices co-located with the MSC that awarded the letter contract action or co-located with another MSC of DARCOM. No attempt was made to identify the source of the charter for the item/system/program/project manager to determine if they reported to and are thus considered on a level with a MSC, HQ DARCOM, or DA.

Many letter contract actions citing a requiring activity mandatory schedule as a reason do not provide any other explanation, such as the need to meet production or deployment schedules. In some instances, file documents showed that the mandatory schedule was driven by the need to avoid production breaks and meet various deadlines imposed by elements outside the control of the requiring activity.

b. Department of Defense (DOD).

DOD imposed mandatory schedules originate in a variety of segments of DOD. They include the Secretary and his Deputy, Under and Assistant Secretaries, the DSARC, Joint Logistics Commanders, the Joints Chiefs of Staff and subordinate personnel and activities reporting thereto. The mandatory schedules include those set by Defense System Acquisition Review Council decisions on test dates, production decisions and Initial Operational Capability (IOC) dates as concurred in by the Secretary. Other mandatory schedules can be set by the Joint Chiefs of Staff in reaction to changes in the threat to the national security or defense.

The DOD represents the highest levels of the Executive Branch responsible for national defense, and a letter contract prerequisite is that the national defense necessitates that the contractor be given a binding commitment to permit immediate commencement of work. Thus, it can be logically argued that a letter contract action resulting from a DOD established mandatory schedule, all other things equal, is a proper application of letter contract policy. But, if the letter contract action results from poor planning or untimely delay in submission of the requirement to contracting, the letter contract action is subject to question.

c. Department of the Army (DA).

The foregoing discussion on DOD also applied to mandatory schedules established on the DA level. Army mandatory schedules include those within the purview of the Army System Acquisition Review Council and the Army Chief of Staff.

d. Other Services and Foreign Military Sales (FMS).

The Army as a single service manager, has commodity assignment or is the sole source within DOD of the expertise and data necessary to procure many items. This results in many Military Interdepartmental Purchase Requests (MIPR's) and FMS agreements for contract placement. Both sources create situations requiring letter contracts.

One use of MIPR's by the military departments is to liquidate obligated funds the departments cannot obligate at the end of the year. A military department will wait until August or September to transmit MIPR's to include miscellaneous funds excess to other program

requirements. MIPR actions can also have a lower priority than obligations incurred within the military department that initiates the MIPR. MIPR funds are considered obligated by the initiating activity once the receiving activity acknowledges acceptance of the MIPR. If the receiving activity element that accepts the MIPR does not coordinate with contracting and production to determine the practicality of a definitive contract by the end of fiscal year to meet the target data of obligation or mandatory schedule, a letter contract can result.

FMS cases have similar problems. Normally FMS case offers are valid for 12 months. If the offer is not accepted until the tenth month and current production ends in eleven months a letter contract is necessary to obtain continuity of production and avoid reopening the case. The FMS case must be reopened because the production break increases the cost of items due to start-up costs or lower production rates. As in the case of MIPR's, if the FMS personnel do not coordinate the FMS case offer terms with the cognizant contracting and production personnel on a timely basis, a letter contract is necessary.

e. Congress.

There are several ways that Congress can cause the use of letter contracts. The first is late appropriation of funds. The Fiscal Year 1980 Appropriation results were not available to field personnel until January 1980. The uncertainty associated with what will be provided in the appropriation acts for individual projects restricts advanced preparation of acquisition package documentation. The Congressional restriction that DOD can not obligate more than 20% of its appropriation

in the last two months of the fiscal year is another complication that may cause the use of letter contracts.

There are instances where Congress dictates certain actions by the DOD. An example is Public Law 92-500 as implemented by DOD Directive 6050.4, Marine Sanitation Devices for vessels owned and operated by DOD. It set a compliance deadline of 1 April 1979. The deadline, test delays and expiring funds caused the modernization component kits for the affected vessels to be obtained by use of a letter contract. Thus, a mandate of Congress can contribute to the need for letter contract awards.

2. Avoid a Production or Performance Break.

This paragraph covers continuing research and development and repetitive supply and service requirements. Because each of these contracts has at least a twelve month period of performance, it is generally known at least a year in advance when a contract will end. Under these circumstances it is difficult to justify avoidance of a production or performance break as a reason for the use of a letter contract. Nevertheless, the reason was cited in a number of instances. There must be a breakdown in the requirements identification process. In some cases after being timely canvassed by the requiring activity, FMS, other services, and DA, activities advised the requiring activity of requirements in a timeframe that requires the use of letter contracts to avoid production breaks. The production breaks can be at GOCO's, GOGO and COCO such as ammunition plants and rebuilt facilities. Production breaks can also be experienced by producers of major and non-major systems requiring government furnished parts, component and subassemblies. Letter contracts have been used to provide continuity of essential support services.

One example is a troop food services requirement. The incumbent contractor protested to the GAO terms of the solicitation for the follow-on requirement. The incumbent contractor kept bringing up new issues to the GAO and delayed the GAO decision for nine months. The Government had to award the incumbent a letter contract to cover the troop food services while the protest was being decided by the GAO. Another example was a requirement for maintenance of test equipment. A two month letter contract was issued to provide time to obtain competition for a ten month requirement, because exercising of an option for a twelve month requirement did not meet the prerequisites of the Defense Acquisition Regulation.

3. Correct Out of Stock Situation.

This out of stock reason is distinguished from the avoidance of a production break in that this reason is driven by end user requisition. It has also been caused by the issue of items of stock to fill FMS case sales. The requisitions cite high priority ratings which lead to negotiated contracts.

4. Obligate Funds Prior to the End of the Fiscal Year.

Although this reason was noted in only eight letter contract files as one of the "official" reasons necessitating the use of a letter contract, it was frequently cited as an unofficial reason for the use of letter contracts. Letter contracts also are used to avoid the loss of expiring monies to avoid the need to re-submit the program under the Planning, Programming and Budget System (PPBS), or to avoid time consuming reprogramming actions and the attendant possible loss of funds.

These contentions are supported in several ways. First the number of letter contracts increases in fourth quarters. The percentage of the

estimated definitive amount which is obligated by the letter contract increases to 90, 95 and even 100 percent. Existing letter contracts awarded at a lower percentage are increased to the 100 percent level. Management at all levels pushes to obligate funds on a timely basis.

In the fourth quarter of fiscal year 1979, $419,419,454 was obligated by letter contract or 44% of total fiscal year 1979 letter contract value. This may account for the Army exceeding its procurement plan by $148 million, and exceeding its obligation plan by $354 million.

C. UNOFFICIAL REASONS.

As stated earlier in this chapter, unofficial reasons are those not cited in primary documentation on the request for and approval of use of a letter contract. Unofficial reasons are identified in miscellaneous pre- and post-award documentation and interviews of contracting and requirements personnel.

1. Contractor Delay in Proposal Submission.

There are contractors that for valid reasons are late in proposal submissions. Other contractors delay proposal submissions for reasons not in the best interests of the Government.

a. Known single source.

A contractor, aware that it is the only source of the supply or service that the Government cannot forego, is in a great position to in essence "name its price" and do so. On the other hand, some contractors are as responsive as though a competitive acquisition exists. Other contractors consider single source Government acquisitions as low priority. The single source acquisition can be considered a booked sale by the

contractor. A higher priority is assigned to new business and competitive acquisitions. One company told the Contracting Officer and the Defense Contract Audit Agency the company's policy was not to obtain and evaluate subcontractor cost or pricing data until a firm order is placed with the firm. This corporate policy resulted in a letter contract for one acquisition. Fortunately, discussions with the contractor's management. eventually changed the policy.

b. Clarification of the Technical Data Package (TDP).

Many acquisitions involve complex, new, advanced state-of-the-art materiels and techniques. It is extremely difficult to reduce these requirements to specifications and drawings. This is particularly troublesome when research and development, full scale production, or new sources are involved. Until a meeting of the minds is reached on the technical data package (TDP), it is difficult, if not impossible, for a contractor to formulate and submit a definitive proposal to the Government.

When design responsibility rests outside the contracting activity the problem of clarification of the TDP is escalated because another party is introduced into the process. Cases were noted where the design responsibility rests within another military service. This complicates obtaining a valid TDP for solicitation purposes as well as clarifications of the TDP for the purpose of proposal preparation.

c. Many Vendors - Many Tiers.

Many items of hardware and development programs are of such magnitude that no one firm can produce without the assistance of many subcontractors or vendors at the first, second, or much lower tiers.

This can be caused by specialization, sophistication, investment costs, scarcity of labor, materials, tooling, etc. The point is that the preparation of proposals is made increasingly difficult and time consuming. Normal leadtimes are thus made impractical. If this is not recognized by the acquisition planners, a letter contract can result.

d. Other Proposal Submission Delays.

Contractors, small and large, enter the Government marketplace every year. The transition from the commercial to the Government marketplace can be traumatic at times as the new Government seller is made aware of the acquisition regulations with their requirements for data, certifications and explanations. Many companies initially are unaware of the breadth and depth of information the Government requires in its dealings with industry. This can increase leadtimes and expand the possibility of a letter contract.

The policy of plant and office closings for holidays and vacation periods become more and more prevalent in industry. If a procurement has a short leadtime for award, a two-week vacation closing can seriously jeopardize the target date of obligation and create the possibility of a letter contract.

2. Meet Obligation Quotas and Avoid Loss of Expiring Funds.

Although cited eight times out of 112 actions reviewed as an official reason for the use of a letter contract, meeting obligation quotas and avoiding the loss of expiring funds was very frequently cited as an unofficial reason for letter contract usage. This reason was cited at the operational level (Contracting Officers and specialists) as well as at

all management levels. In many observed instances the preceived reasons were the meeting of obligation quotas and avoiding the loss of expiring funds, although this is not cited in the request for approval of a letter contract.

3. Lack of Management Support of the Principal Contracting Officer (PCO).

The extent to which contracting organizations challenge requiring activities and contractors on late submission of data and incomplete data strongly influence the Principal Contracting Officers (PCO's) opportunity to avoid letter contracts. A lower incidence of letter contracts was observed in those MSC's which hold the requirement personnel responsible for late receipt of contracting packages, and stand behind their PCO's resistence to requirements personnel pressure for a letter contract. These MSC's also support the PCO's in resisting contractors reluctance to submit complete proposal data and to negotiate in a reasonable manner to reach a definitive rather than letter contract agreements. In those MSC's which acquiesce to the demands of requirements personnel for letter contracts and contractor delay tactics in reaching definitive agreements, a higher incidence of letter contracts was observed. Thus the degree to which a MSC supports its PCO in resistence to in-house and outside pressures for letter contracts has a direct influence on the rate of letter contract use.

4. Lack of Requirements Management.

The file documentation and interviews show requirements and other non-contracting elements frequently generate the need to use a letter contract. This is caused in several ways.

Some requirement activities are well aware of procurement administrative leadtimes (PALT's). They do not ignore PALT's but use PALT to make up

schedule slippages that occur elsewhere in the overall program. For instance, the major milestones in many programs are set years in advance and are considered sacrosanct regardless of actual events. This is true even though technical difficulties, such as delayed or repetitive tests occur or if leadtimes have expanded. To make up those time shortfalls, PALT is sacrificed and letter contracts result.

Decisions made by Project Managers (PM's) and high levels are not transmitted to cognizant technical and contracting personnel in a timely manner. This could be done on an informational, if not on an action basis. Usually the people at the end of the contract placement process are not advised of higher level decisions until planning and resource allocation leadtime is gone. There are few, if any, alternatives to the use of a letter contract to meet required schedules. In other words, contracting personnel are not provided the time to revamp workloads and resource or take actions necessary to achieve a definitive rather than a letter contract.

5. Miscellaneous Reasons.

Miscellaneous reasons for the use of letter contracts are those observed in only a few instances, but were supported by other evidence.

One letter contract resulted from a delay in making a decision on whether a development or a readiness MSC would be the mission agency for the requirement. An MSC submitted an acquisition plan in a timely manner for a subsystem of a system for which another MSC was responsible. Higher command levels returned it for incorporation into the acquisition plan of ultimate end item. Requirements that must be coordinated with numerous departmental or interdepartmental elements have a much greater leadtime than

strictly in-house requirements. This is not known or considered by schedule, performance or delivery decision makers.

Field requirements and contracting personnel have stated that processing of Secretarial Determination and Findings (SEC D&F's), specifically for authority to negotiate for research and development (R&D)can lead to letter contracts. Data was extracted from 112 letter contract actions valued at $195,622,448. Thirty-nine (34%) of the actions valued at $42,942,378 (21%) were for research and development (R&D) acquisitions.

In one case a SEC D&F for a $250,000 R&D acquisition was dispatched from the MSC in September. The signed SEC D&F was received by the PCO the following January. This is another example of the necessity for a letter contract being beyond the control of the requirements or contracting activity.

D. SUMMARY.

Reasons for the use of letter contracts include mandatory schedules, economics, indecision, management philosophies and attitudes as well as outright poor planning. At times only one reason is germane. In other instances several reasons are involved and can be of a cumulative nature (one leads to another).

The persons or entities which constitute the primary reason(s) for use of a letter contract are just as varied. It can be the cognizant contracting or technical individual or element, an organization element's formal or informal policy, a high or low level official or decision body, and all can be on either side of contract (Government or contractor or both in case of personality conflict).

The point is, letter contracts are often caused by poor policy, planning, and communications. These must be recognized and their impact on the use of letter contracts minimized. The way to minimize the use of letter contracts will be the subject of the next chapter.

CHAPTER V

TECHNIQUES FOR THE IMPROVEMENT OF LETTER CONTRACT USE

A. INTRODUCTION.

Many vehicles for improvement of letter contract use were identified during the course of the study. As there are many causes of letter contracts, there also are many techniques for reducing unwarranted usage. While eliminating letter contracts altogether or setting strict goals on their use were suggested by some officials during the course of the study, neither is considered a practical approach and will not be discussed. The following techniques and management approaches are considered to be practical.

B. ASSIGN ACCOUNTABILITY.

This technique is based on AR 1000-1, "Basic Policies for Systems Acquisition," paragraph 2-4, which states in part, "When a line official above the PM exercises decision authority on program matters, that decision will be documented as official program direction to the PM and the line official will be held accountable for the decision." Many letter contracts are caused by decisions made by levels higher than the PM or MSC. These levels include DARCOM HQ, the ASARC, DSARC departmental secretaries and Congress. In cases where the decision is unrealistic, it is incumbent on the PM to request relief. The request must be documented. Any denial will become a part of the pertinent official contract file and references in any request for and approval of the use of a letter contract. Accountability for the need to use a letter contract will then be properly placed. If the contracting and requirements personnel

are not responsible for the need to use a letter contract, then they must not be criticized for the same. If contracting or requirements personnel are the basic cause for the need for a letter contract they must be held accountable.

C. USE PROPER LEAD TIME IN THE BUDGET CYCLE.

The Planning, Programming and Budget System (PPBS) must take into consideration the lead time experience of most defense items. Lead times for large forgings and castings, bearing machining capacity, semi-conductors and metals have increased significantly. Heavy forging lead times can exceed two years. Lead times of 30 to over 90 weeks are experienced for bearings and fasteners. Some types of machining jobs are being booked more than two years in advance. Integrated circuit lead times have increased to 12 months compared to five a year ago. Contributing to the lead time problem is a shortage of technical workers revealed by a recen survey of the National Machine Tool Builders Association.[8] The Fiscal Year 1981 budget submission reflected long lead time funds for a few systems, but not to the extent envisioned by the above discussion. The lack of recognition of realistic lead times by the PPBS will dictate the need to use letter contracts to meet mandatory schedules.

It is recognized that contracting offices have an opportunity to adjust required leadtimes from those in the PPBS documents. The preceived problem is when, for example, the PPBS document is based on a production leadtime (PDNLT) of 12 months with no change in the mandatory schedule and the administrative leadtime (ALT) remains constant at 12 months. In a case like this, the PDNLT has eliminated the ALT and the only way to meet the mandatory schedule is use of Letter Contract.

Late Congressional actions on the appropriation acts is beyond the control of the Executive Branch. If letter contracts are caused by late Congressional action the file should be so documented and attention focused on other causes of letter contracts.

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[8] McGraw-Hill, Inc., Business Week, Number 2622, February 4, 1980, pp 80-86.

D. RAISE THE THRESHOLD FOR SECRETARIAL R&D NEGOTIATION AUTHORITY.

Currently all determination and findings (D&F) Authority to Negotiate for individual and classes of contracts for research and development that exceed $100,000, require secretarial approval. Obviously, $100,000 does not buy as much now as it did in 1962 when the threshold was last raised. Inflation alone has eroded the value of the dollar. Additionally, the cost of technological advancement has increased as technology has increased in sophistication. The administrative time and cost of processing low dollar value Secretarial D&F for R&D outweigh the value of the reviews and approvals. This administrative burden deters prompt exploitation of technology and immediate response to ever changing threats to and needs of the national defense. This led to the unintentional but unavoidable use of letter contracts.

The Department of Defense (DOD) is ". . . considering asking Congress to raise, from the current $100,000 to $1 million, the threshold for requiring top DOD approval of Determinations and Findings (justifying negotiation in place of formal advertising)."[9] The favorable consideration by DOD and speedy action by the Congress will improve the procurement system in general and specifically the use of letter contracts.

E. PLAN.

Armed with realistic definitive contract lead times, planners can take the necessary action to assure letter contract use is at a minimum. The most comprehensive plan cannot guarantee the elimination of letter contracts. FMS cases, poor projections and human error are facts of life. Yet with proper planning they need not result in the use of letter contracts.

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[9] Federal Contracts Report, No. 815, 21 January 1980, page K-2, The Bureau of National Affairs, Washington, DC.

Proper planning must involve all concerned elements, including outside customers, requirements, production, contracting and comptroller. Oral communications are important. Notices can be sent and plans written, but if follow-up action is absent the result will be unsatisfactory. All acquisition disciplines must function as members of the team interacting in a continuous and dynamic manner.

F. GIVE PROPER NOTICE.

Proper notice includes all those involved in the acquisition process. The customer and requirements must be put on notice of the lead times to permit contract award by definitive contracts in lieu of letter contracts. This is the responsibility of contracting personnel.

Requirements personnel in the MSC must advise customers in outside activities of the requirements and contracting lead times necessary for definitive contracts. Outside activities include PM's and other MSC's and services. The key is to insist on adherence to the contracting lead times. If management levels of the MSC do not support contracting and requirements operations personnel in insisting on proper lead times, no positive results will occur from the notice.

G. CHALLENGE UNREALISTIC REQUIREMENTS.

Unrealistic requirements have many sources. They include restrictive specifications, inadequate estimates and funds, and unrealistic obligation dates and delivery or performance schedules.

DAR 3-800 is pertinent to this method of reducing letter contract usage. Although the title of this part of the DAR is entitled, "Price Negotiation Policies and Techniques" it brings the roles of the members of

the acquisition team into perspective. Appropriate cites follow.

> "3-801.1 General. It is the policy of the Department of Defense to procure supplies and services from responsible sources at fair and reasonable prices calculated to result in the lowest ultimate overall cost to the Government. Good pricing depends primarily upon the exercise of sound judgement by all personnel concerned with the procurement.
>
> 3-801.2 Responsibility of Contracting Officers. (a) Contracting officers, on their authorized representatives acting within the scope of their authority, are the exclusive agents of their respective Departments to enter into and administer contracts on behalf of the Government in accordance with DAR and Departmental procedures. Each contracting officer is responsible for performing or having performed all administrative actions necessary for effective contracting. . ."
>
> 3-801.3 Responsibility of Requirements and Other Logistics Personnel in Purchasing Offices. Personnel other than the contracting officer, who determine type, quality, quantity, and delivery requirements for items to be purchased, can influence the degree of competition obtainable and exert a material effect upon prices. Failure to determine requirements in sufficient time to allow:
> (i) a reasonable period for preparation of requests for proposals;
> (ii) preparation of quotations by offerors;
> (iii) contract negotiation and preparation; or
> (iv) adequate manufacturing leadtime, causes delays in deliveries and uneconomical prices. Requirement issued on an urgent basis or with unrealistic delivery schedules should be avoided since they generally increase prices or restrict desired competition."[10]*

Since letter contracts may increase the price the Government pays for a supply or service it is the responsibility of all acquisition participants to avoid unrealistic contracting requirements. The DAR also

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[10]Department of Defense, Defense Acquisition Regulation, 1976 Edition.

*Note: Although 3-801.3 literally refers to contracting office personnel, it should apply to all acquisition process participants from the requisitioner or end user to the MSC.

places the ultimate responsibility on the contracting officer to challenge any unnecessary contracting aspects. The contracting officer must closely scrutinize the circumstances that dictate the need for a letter contract. If in the contracting officer's judgement a letter contract is not warranted, the requirement must be returned to requirements personnel for elimination of the unrealistic aspects of the contracting package.

H. ASSURE MANAGEMENT SUPPORT OF THE CONTRACTING OFFICER.

Failure of contracting officers to challenge unrealistic or incomplete contracting packages and incomplete or delayed contractor data has been expressed as an area of concern by both contracting and requirements personnel. The foregoing failure of contracting officers has been attributed to lack of management support of the contracting officer. Lack of management support of the contracting officers challenging unacceptable requirements and contractors data causes morale problems, compromises the integrity of the contracting process, and is not in the best interests of the Government.

The management of some MSC's are exemplary in their support of the contracting officer over the use of letter contracts. They have taken a written official position discouraging letter contract usage or support contracting officer refusal to issue letter contracts at the end of the fiscal year to meet obligation goals. Other MSC's encourage the use of letter contracts for the primary purpose of obligation of funds.

I. DOCUMENT THE FILE.

The contract file must fully document the reasons for the need to use a letter contract. If the reasons that led to a letter contract

are not the responsibility of contracting personnel then requirements personnel or other customers must present the facts that require the use of a letter contract. The facts must be accurate and complete. The documentation must include the steps that were taken in the past to place the requirement by use of definitive rather than a letter contract. Examples are: prior coordination with all acquisition personnel to save time by utilization of draft work statements and solicitations; solicitations issued subject to the availability of funds; and the use of precontract costs advanced agreements.

J. <u>CONSIDER PRECONTRACT COSTS ADVANCED AGREEMENTS</u>.

DAR 15-205.30, "Precontract Costs" provides an alternative to the use of a letter contract. It defines precontract costs as: "..... Those incurred prior to the effective date of the contract directly pursuant to the negotiation and in anticipation of the award of the contract where such incurrence is necessary to comply with the proposed contract delivery schedule. Such costs are allowable to the extent that they would have been allowable if incurred after the date of the contract."

A review of case law precedent through the Federal Legal Information Through Electronic (FLITE) showed no instance where precontracts costs agreements in accordance with DAR XV resulted in the Government being held liable when the contemplated contract did not materialize and the Government did not receive something of value. The reason is that advanced agreements contain language substantially as follows: "In the event a contract is not consummated between the parties, the Government shall not be liable for any of the costs incurred, and the incurrence of such costs is solely at the contractors risk."

Although precontract costs advanced agreements have been used in the past as an alternative to the use of a letter contract, only one Major Subordinate Command (MSC) has it as a written policy. That MSC had only one letter contract in fiscal year 1979 and the letter contract was for a requirement from another MSC. Other MSC's informally discourage precontract costs agreements and prefer letter contracts. A contracting officer at one of the MSC's that discourages precontract costs advanced agreements stated that five of ten letter contracts he awarded could have been avoided by the use of precontract costs advanced agreements. Thus this alternative to the use of a letter contract can be attractive and has proven to be effective.

K. UTILIZE OPTIONS.

The use of contract options is a valid way to avoid use of a letter contract for a production or service under a fixed-price type contract. The need for a definitive work statement and cost or pricing data does not make this a viable technique under cost type contracts. It must be pointed out that letter contracts were used even though options of 200% or more of the basic contract quantity existed on previously awarded definitive contracts. Unforeseen or unforecasted demands from FMS and other sources used all available option quantities and still forced the use of letter contracts.

L. DEVELOP FLEXIBLE APPROVAL POLICY.

There are two aspects to a flexible letter contract approval policy. The first is what organizational element should prepare and process the request and secondly, at what organizational level should the request be approved or disapproved.

The decision on these items would be left to the purview of the individual commanders of the MSC's. If letter contract usage is not perceived as a problem by the commander and his staff, approvals should be at the lowest possible level and the originator and coordinator of the request can be requirements or contracting personnel.

On the other hand, if letter contract use is a problem caused predominantly by requirements personnel and their customers, requirements personnel can be tasked to generate and staff the request documentation. Additionally, the approval level can be elevated as high as the commander.

M. RECOGNIZE POTENTIALLY CONFLICTING POLICIES.

Current DARCOM policies can be in conflict with each other. On the one hand HQ DARCOM stresses meeting obligation goals reported on DARCOM Form 2423, "Monthly Award Forecast and Not Forecast Values (APARS)" for the entry into the Army Procurement Appropriation Reporting Support System (APARS). On the other hand, HQ DARCOM policy is to reduce the use of letter contracts. Reduction in letter contract use is the priority in the first half of the fiscal year and obligation rates have priority in the last half of fiscal year. HQ DARCOM must recognize this conflict in policy prior to criticizing the MSC's for year end letter contract usage.

N. IMPROVE HQ DARCOM MONITORSHIP.

HQ DARCOM will improve its visibility of the letter contract picture by improving the letter contract report as discussed in Chapter II, paragraph D.2. If an MSC or a particular requiring activity or customer appears to be creating a letter contract problem HQ DARCOM can require a briefing to include corrective action to alleviate the problem.

CHAPTER VI

CONCLUSIONS AND RECOMMENDATIONS

A. INTRODUCTION.

A letter contract is an essential option available to the Contracting Officer in selection of the method to achieve a binding two party agreement for supplies and services for the national defense. Although not a preferred option it is unquestionably a necessary one. What is questioned is the reasons given for the use of letter contracts. The lessons learned from the past is a basis for improvement in the future. The conclusions constitute the lessons learned and the recommendations offered to make improvements for the future on the use of letter contracts within the US Army Materiel Development and Readiness Command (DARCOM).

B. CONCLUSIONS.

1. Letter contracts are not per se a contracting problem. They are more of an acquisition problem. The conditions that cause the need for a letter contract exist prior to the requirement reaching the contracting office. Many times contracting personnel are faced with no realistic alternative to the use of a letter contract.

2. The reason most observed for the use of letter contracts (over 75%) was to meet mandatory schedules set by the requiring activity, the customer, and higher authority.

3. Pressure to obligate funds to meet quotas and to avoid the loss or reprogramming of funds is a major reason for the use of letter contracts, although not always an official reason cited in requests and approvals of

letter contracts.

4. Techniques for letter contract reduction are as varied as their causes. Opinions on methods to reduce letter contract usage range from eliminate them completely to the status quo is reasonable. A few are not practical but many more are. The keys to the use of the techniques identified to reduce the use of letter contracts is judgment and flexibility.

5. The degree to which MSC management consider letter contracts acceptable and the degree to which management stands behind the contracting officer affects the level of letter contract use.

6. The increased leadtimes for materials and supplies and the scarcity of essential labor skills for defense supplies and services, combined with a lack of timely obligation authority due to deficiencies in the Planning, Programming and Budget System (PPBS) contribute to the increased use of letter contracts.

7. The current $100,000 threshold of Secretarial Determination and Findings (D&F's) Authority to Negotiate for Research and Development (R&D) is impractical and outdated. R&D effort accounted for 10 to 15% of the DARCOM fiscal year 1979 letter contract dollars. An increase in the threshold for Secretarial D&F's for Authority to Negotiate for R&D will provide administrative leadtime to reduce the use of letter contracts for R&D.

8. The DARCOM Procurement Instruction (DARCOMPI) guidance on the use of a precontract costs advanced agreement as an alternative to the use of a letter contract, documenting the steps taken to avoid the use of a

letter contract, and reports on the use of letter contracts can be improved.

9. Headquarters DARCOM has a potential conflict of goals between reduction of letter contract use and achievement of funds obligation goals.

10. Although there is a consensus that letter contracts cause additional administrative costs, there is not a similar consensus on whether letter contracts cause additional performance costs.

11. Current Defense Acquisition Regulation (DAR) and Army DAR Supplement (ADARS) guidance on the use of letter contracts is adequate.

C. RECOMMENDATIONS.

The following recommendations are directed towards the future of letter contracts within the US Army Materiel Development and Readiness Command (DARCOM).

1. HQ DARCOM must recognize the potential conflicting policies on the obligation of funds and the use of letter contracts or eliminate the conflict by deciding which policy has priority.

2. HQ DARCOM and its MSC's must carefully evaluate the techniques for reduction of the use of letter contracts and apply the techniques to the extent appropriate.

3. The PPBS must realistically reflect the increased lead times associated with defense acquisition. This includes stockpiling of appropriate materials and components. [11]

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[11] US Army Materiel Development and Readiness Command (DARCOM), DARCOM Circular No 715-2-80, Section III, "Troop Support and Aviation Materiel Readiness Command (TSARCOM) Leadtime Initiatives," 11 February 1980.

4. Action must be taken to raise from $100,000 to $1,000,000 the threshold of Secretarial Determination and Findings Authority to Negotiate for research and development.

5. The DARCOMPI should be revised to improve the quality of letter contract reports to HQ DARCOM. The reports should reflect the activities such as end user, design agency, project manager, ASARC, DSARC, etc., that contributed to or can minimize the need for a letter contract. Both the percentage of the total estimated definitized price obligated by the letter contract and incurred by the contractor should be reported, to permit review of compliance with DAR 3-408(c)(3)(ii) and 3-408(c)(4). This will enhance visibility of field use of letter contracts.

6. The DARCOMPI should be revised to address consideration of pre-contract costs advanced agreements, if equitable and obtainable, as an alternative to the use of letter contracts.

7. The requests for approval of use of a letter contract must include: alternatives considered; steps taken to avoid the use of a letter contract; and acquisition team members or activities that contributed to the need for the use of a letter contract.

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US Department of the Army, Army Defense Acquisition Regulation Supplement, 1976 Edition

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APPENDIX A

DAR 3-408 LETTER CONTRACT

(a) Definition. A letter contract is a written preliminary contractual instrument which authorizes immediate commencement of manufacture of supplies, or performance of services, including, but not limited to, preproduction planning and the procurement of necessary materials.

(b) Application. A letter contract may be entered into when (i) the interests of national defense demand that the contractor be given a binding commitment so that work can be commenced immediately, and (ii) negotiation of a definitive contract in sufficient time to meet the procurement need is not possible, as for example, when the nature of the work involved prevents the preparation of definitive requirements, specifications, or cost data.

(c) Limitations.

(1) A letter contract shall be used only after a written determination that no other type of contract is suitable.

(2) A letter contract shall not be entered into without competition when competition is practicable. Where a letter contract award is based on price competition, an overall price ceiling shall be included in the letter contract.

(3) A letter contract shall include an agreement between the Government and the contractor as to the date by which definitization is expected to be completed and a definitization schedule, as required by 7-802.5. This date shall be prior to:

(i) the expiration of 180 days from the date of the letter contract; or

(ii) forty percent (40%) of the production of the supplies, or the performance of the work, called for under the contract, whichever occurs first.

In extreme cases, an additional period may be authorized.

(4) The maximum liability of the Government stated in the letter contract will be the amount estimated to be necessary to cover the contractor's requirements for funds prior to definitization, but this amount shall not exceed fifty percent (50%) of the total estimated cost of the procurement unless advance approval is obtained from the official authorizing the letter contract.

(5) The total estimated cost shall not exceed the funds available for obligation and commitment in the appropriate allotment account. Therefore, the letter contract shall not describe, refer to, or otherwise commit the Government to a definitive contract in excess of the funds available for obligation and commitment at the time the letter contract is executed.

(6) Amendments to letter contracts to accomplish new procurement may be used only if the new procurement is inseparable from the procurement covered by the existing letter contract. Such amendments are subject to the same limitations as new letter contracts.

(d) Definitization. A letter contract shall be superseded by a definitive contract at the earliest practicable date and not later than the target date established in the Definitization clause or any extension thereof by the contracting officer. To cover unusual cases in which the

Government and the contractor, after exhausting all reasonable efforts, cannot negotiate a definitive contract because of failure to reach agreement as to price or fee, the clause in 7-802.5 requires the contractor to proceed with the work and gives the contracting officer the right, with approval of the Head of the Procuring Activity, to determine a reasonable price or fee in accordance with Section III, Part 8, and Section XV, subject to the Disputes clause.

(e) Content. Letter contracts shall be specifically negotiated and, as a minimum, shall include the clauses required by Section VII, Part 8. Whether executed on Standard Form 26 or Standard Form 30, a definitized contract will be numbered as a modification of the letter contract as provided in 20-204.3(a).

APPENDIX B

DARCOM PI 3-408

<u>3-408 Letter Contracts</u>.

(a) The written determination required by DAR 3-408(c)(1) shall include an outline of the reaons for a letter contract and the alternatives considered, and shall have attached thereto a phased plan for execution of the difinitized contract within a total elapsed time of four (4) months. The plan shall include the following milestone dates:

(i) submission of quotation or proposals;

(ii) completion of audit and cost price analysis;

(iii) completion of negotiations; and

(iv) signature of the definitized contract.

(b) Problems arising which will delay definitization shall be brought to the attention of the commander of the subordinate command prior to the target date for definitization.

(c) Letter contracts for weapons support systems covered by cost information reports (CIRs) shall contain requirements that collecting and reporting CIR data shall start as soon as the contractor begins work on the contract.

(d) Requests for the use of a letter contract shall be approved only by the HCA, hiw deputy, and principal or deputy principal assistant responsible for procurement.

1. Dollar value of amendments shall be entered on line 2, but the amendment shall not be added into the number column.

2. The sums of entries on lines 1 and 2, minus entries on line 3, shall equal the entries on line 4.

3. Entries on line 4 shall be aged on lines a through c, the age to be computed from the date of each basic letter contract through the end of the report period.

4. For each letter contract awarded during the report period, include justification as a footnote. For each letter contract definitized during the period, include contract number and date of definitization.

5. In addition to the format indicated, the report shall provide a separate listing of all outstanding letter contracts as of the end of the report period indicating:

(i) Installation

(ii) Contractor

(iii) Contract Number* and Amendment or Modification Numbers

(iv) Date entered into

(v) Dollar Amount Obligated (Estimated Contract Value)

(vi) Item

(vii) Quantity

(viii) Estimated Definitization Date

(ix) Percentage complete

(x) Reason not definitized at end of period

6. The separate listing shall be prepared on 8- by 13- inch paper, in duplicate, and shall be clear, legible copies.

*Identify by one asterisk if over 6 months or forecast to become 6 months old

APPENDIX C

DARCOM PI 3-408.60 and .61

3-408.60 Letter Contracts Awarded, Definitized, and Outstanding.

(a) Heads of Procuring Activities who award letter contracts shall prepare and submit quarterly reports on Letter Contracts Awarded, Definitized, and Outstanding, in the format of 3-408.61. Reports shall be signed by an individual named in APP 1-150(c) and submitted in duplicate to the addressee in APP 1-150(b)(11), ATTN: DRCPP-SO, by the 10th workday after the close of each quarter year. Negative reports are required.

(b) For reporting purposes a letter contract consists of a basic letter contract withall amendments and shall be reported as a single letter contract. The total obligated dollar value of the basic letter contract combined with the obligated dollar value of all amendments shall be included. Letter contracts and amendments designated as supplemental agreements to definitive contracts shall be considered as a letter contract and shall be reported as such.

(c) The dollar amounts to be reported shall be obligated amounts prior to definitization. Definition shall be considered complete when a definitized contract is signed by Government and contractor representatives.

3-408.61 Format for Report on Letter Contracts Awarded, Definitized, and Outstanding.

DARCOM Form 2416-R "Letter Contract Report" and Form 2416-1-R "Letter Contracts Awarded, Definitized & Outstanding", are located in Appendix F.

Instructions:

APPENDIX D

DARCOM LETTER CONTRACTS REPORT

LETTER CONTRACTS AWARDED DEFINITIZED AND OUTSTANDING	REPORT CONTROL SYMBOL DRCPP-307	
TO: Commander US Army Materiel Development and Readiness Command ATTN: DRCPP-SO	FROM: Commander	
REPORTING PERIOD FROM:	TO:	
STATUS	NUMBER	DOLLAR AMOUNT
1. Not definitized at beginning of period.		
2. Entered into during period.		
3. Definitized during period.		
4. Not definitized at end of period - total		
a. Under 6 months.		
b. 6 months up to 12 months.		
c. 12 months or more.		
TYPED NAME AND TITLE:		

APPENDIX E

STUDY TEAM COMPOSITION

The study team consisted of the following individuals:

C. Eugene Beeckler, Project Officer and Procurement Analyst, US Army Procurement Research Office (APRO), US Army Logistics Management Center (ALMC), B.B.A., University of Wisconsin, 1961; M.S. in Procurement and Contract Management, Florida Institute of Technology, 1976. Mr. Beeckler has worked on APRO projects in the areas of warranties, change order administration, evaluation and negotiation of IR&D and B&P costs, and Acquisition Strategies for Nondevelopmental Items. Mr. Beeckler was a Contract Specialist with the AMC Chicago Procurement District, the NIKE-X Project Office and various Commands assigned to Ballistic Missile Defense Program. Mr. Beeckler was also a Supervisory Contract Specialist/ Contracting Officer with the US Army Procurement Agency, Europe, Frankfurt/Main, FRG. After a short assignment as a Contract Negotiator with the Army Missile Command, Mr. Beeckler joined the APRO.

John I. Neely is an Indistrial Engineer at US Army Procurement Research Office, US Army Logistics Management Center, Fort Lee, Virginia. He earned his M.S.I.E. from Purdue (1942) and has a B.S. in Education from Indiana University (1938). Mr. Neely has been licensed as an Industrial Egnineer in several states. Prior to coming to the US Army Procurement Research Office (APRO), he was an Industrial Engineer with the Defense Logistics Agency, and taught I.E. for the US Navy in the Far East. He received the civilian "E" Award from President Roosevelt for R&D at Eli Lilly and Company.

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13. ABSTRACT

The study objectives were to determine factors in the establishment of requirements, contract administrative leadtime and acquisition planning that lead to the use of letter contracts and recommend any necessary changes to current policy and procedures for the use of letter contracts. The authors reviewed current policy, selected review and analyzed pre-award letter contract files, and interviewed contracting policy and operations and requirement personnel at selected US Army Materiel Development and Readiness Command Major Subordinate Commands. Both official and unofficial reasons for letter contracts and techniques for the improvement of letter contract use were identified. A letter contract is an essential option available to the contracting officer in selection of the method to achieve a two party agreement and immediate commencement of work for supplies and services for the national defense. Other findings, conclusions and recommendations are provided in the study.